$50.00 ANNUALLY
40 Letters Per Year

DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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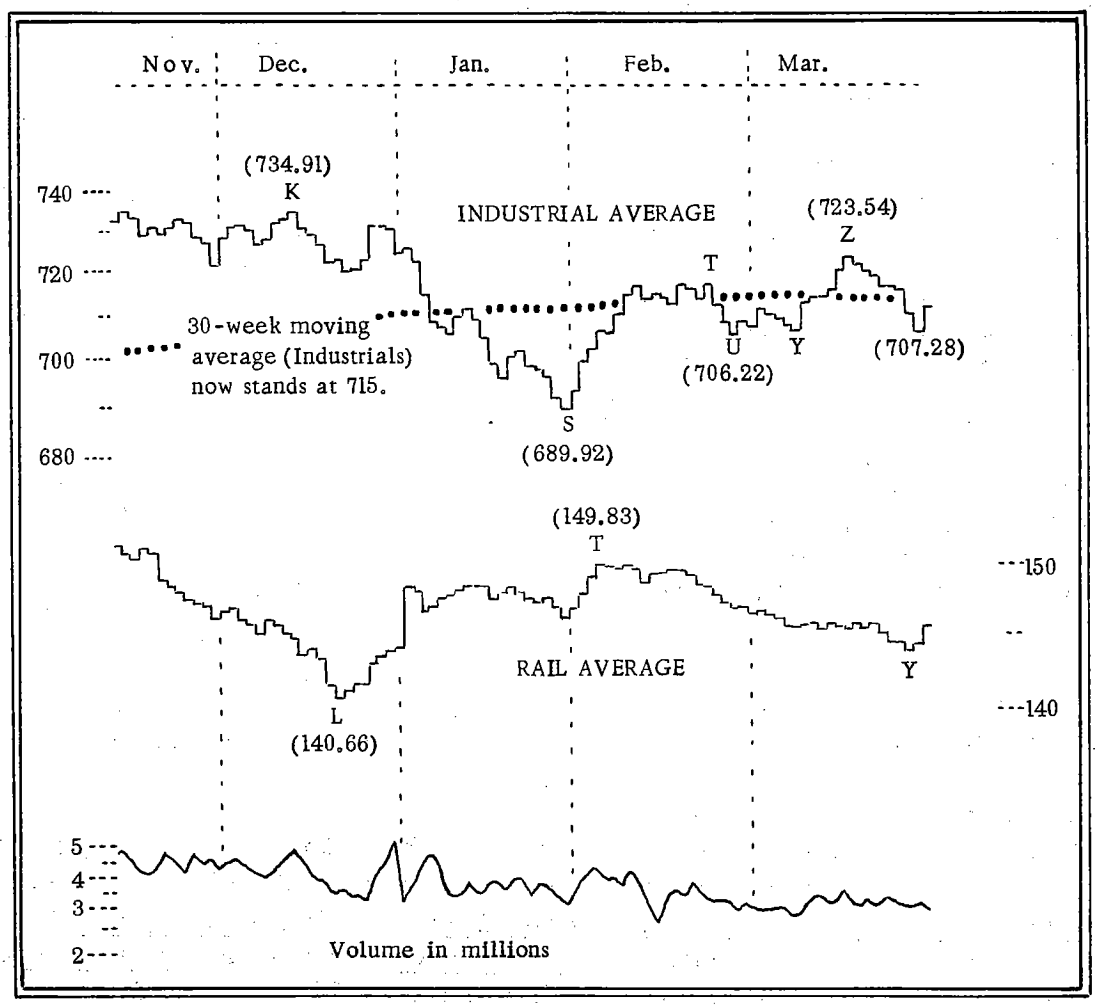
THE MARKET The last Letter drew attention to the weakness of the rally which terminated on March 15 (Y to Z). As if to underscore the negative condition of the market, five days after the peak at Z, the Rails turned down and broke below their trading range of the entire year. On March 26 the advance-decline ratio (see next section) dropped under its February and March bottoms. On March 27 Industrials closed at 707.28, exactly 1.06 points above the February low at U (706.22). This non-confirmation by Industrials, following seven out of eight days of decline, could provide the spark for a rally to new recovery highs (above Z -- 723.54). As will be seen shortly, this observer is anything but bullish about the potentialities of such a rally.

Since a further understanding of the situation is almost impossible without a discussion of the relationship of the advance-decline ratio and the Industrial Average, I will now go into an examination of those two indicators.

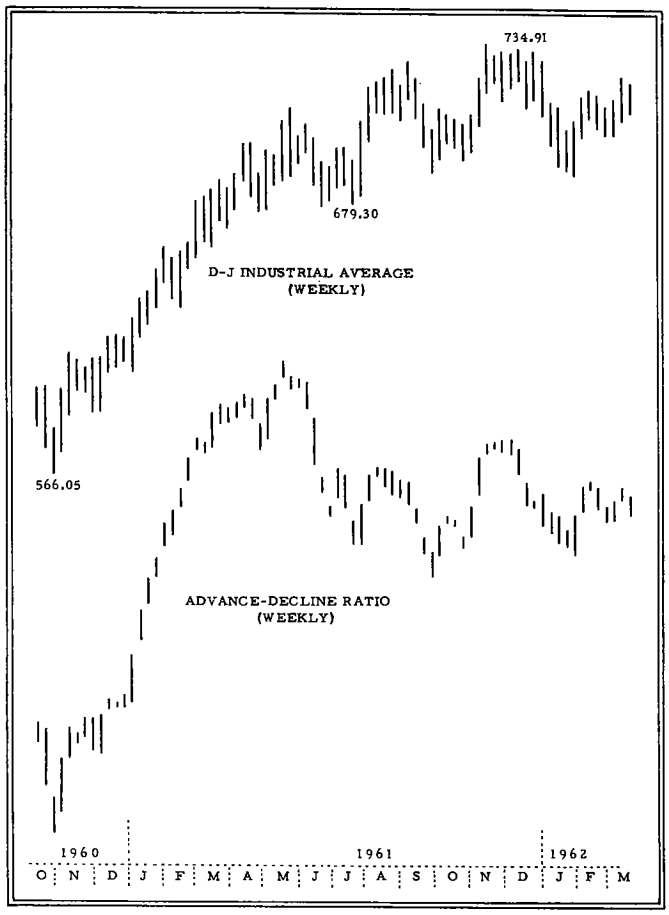
A CRITICAL STUDY Subscribers may be wondering why, over the last month or so, I have dwelled at such length on the advance-decline ratio (A-D ratio). The reason is that the A-D ratio is one of the few indicators which has been telling an important story. From past history we know the following: (1) The Industrial Average alone cannot produce a bull or bear swing -- unless it has the rest of the market (i.e., the A-D ratio) behind it. (2) The majority of stocks (i.e., the A-D ratio) will not produce a bull or bear swing -- unless they have the investment grade issues, as represented by the Industrial Average, behind them. (3) We know that at certain times the two indicators seem to get hopelessly "out of gear". When this happens, a stalemate or a change in direction is imminent.



So that subscribers may have a better understanding of the fascinating picture which is now developing, I have included two charts showing the relationship of the Industrial Average and the A-D ratio. Both charts are of critical importance and should be studied carefully.

The first (weekly) chart shows a concentrated picture of the entire swing from October, 1960, to the present. Here, in a nutshell, we see the reason behind the stalemate of 1961-62. Note that the A-D ratio and the Industrials recorded joint

peaks in May, 1961. Following the May highs, the two indicators turned down. Industrials recorded their low (679.30) in July, but the A-D ratio continued to retreat during the next two months. By September, the A-D ratio had penetrated its July low and dropped back to the levels of January, 1961. The Industrial Average, however, refused to break its own July low and thereby failed to confirm the September low of the A-D ratio.

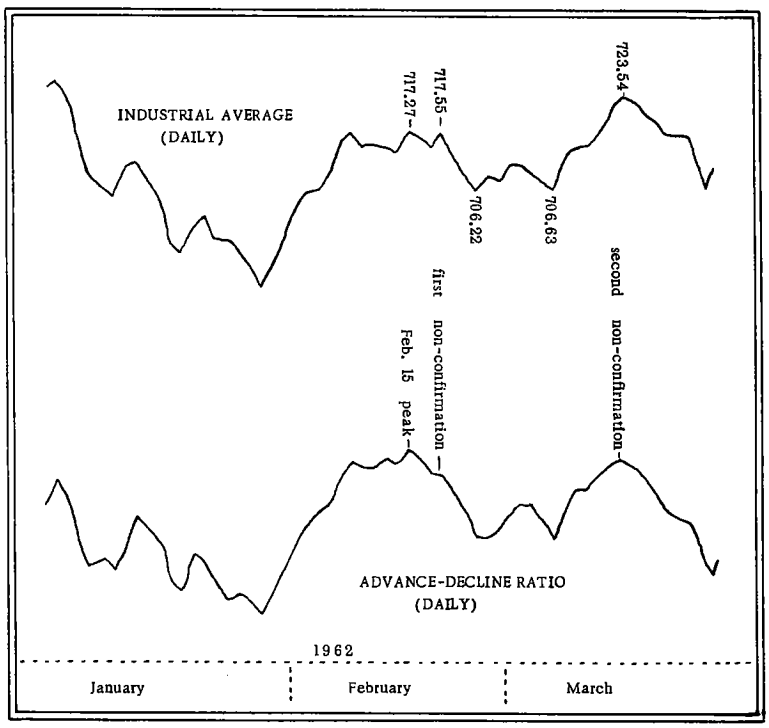


Following this non-confirmation, Industrials rallied sharply, and by December they had risen to a record high of 734.91. This new high was not confirmed by the A-D ratio. In other words: (A) The Industrial Average would not confirm the September, 1961 low on the A-D ratio. (B) The A-D ratio would not confirm the December high on the Industrial Average. This series of major non-confirmations had the effect of holding the market in a "technical vacuum" throughout most of 1961 and the first half of 1962 (despite almost unanimous predictions for a continuing "Kennedy market boom").

Is there a rationale for this action? Perhaps so, and it may well be that the market has been saying that the stocks of the great majority of American companies have not been able to respond to the favorable factors which produced new average highs on thirty of the nation's largest corporations.

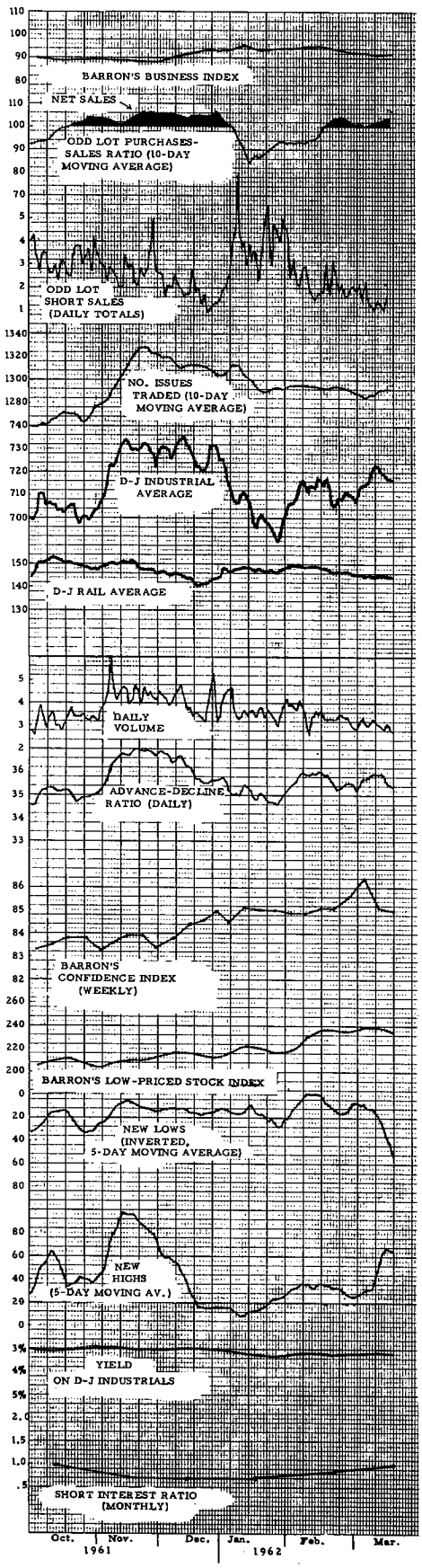
The second chart shows the daily action of the two indicators for 1962. This is an equally fascinating picture which should be clearly understood by subscribers. The daily chart suggests that the market may finally be moving into position to provide a conclusion to the technical stalemate of the last year.

On February 15, 1962, the A-D ratio and the Industrial Average rose to joint recovery highs (Industrials 717.27 -- see chart). Three days later, Industrials rose to another recovery high of 717.55. This recovery peak was not confirmed by the A-D ratio and both indicators then declined into March.



The rally which began on March 7 produced a new Industrial recovery high of 723.54 on March 15, but for the second time the A-D ratio refused to confirm. This action touched off the most recent decline. On March 26 the A-D ratio broke below both the late February and the early March lows. On March 27 the decline continued, but by the close it was seen that although the A-D ratio registered a new low for the move, the Industrials refused to confirm by penetrating their 706.22 low.

As of this writing, two possibilities present themselves: (1) If Industrials hold persistently above the February low of 706.22, the stage will be set for a new Industrial rally -- perhaps to a recovery high above 723.54 or even above the record high of 734.91. As seen on the chart, however, such a high would be almost sure to produce a third non-confirmation by the A-D ratio (the A-D ratio is now too low to confirm). Triple divergences have preceded all major reactions and bear markets since 1919 (see Letter 170 on triple divergences). Therefore,



I would take an Industrial high above 723.54 as a definite danger signal! Any rally above the 723.54 level should be used as a broad selling area.

(2) On the other hand, if Industrials now confirm the weakness of the A-D ratio by closing below 706.22, the possibility of an extremely bearish triple-divergence will be eliminated. If the decline then continues to the 680 or below area, this could produce a "sold-out" condition and the possibility of a forthcoming profitable advance. Lacking a sold-out situation, however, I see merely an extension of the frustrating trading range of the last year.

THE INDICATORS As seen on the indicator chart, what technical strength now exists is confined to the odd-lot transactions and the Confidence Index. (1) Odd-lots have once again move to the selling side of the market, although since early February there has been little actual change in sentiment (and it is the change which is important). Odd-lotters have stayed bearish but have not turned very much more bearish. (2) The Confidence Index registered a new recovery high of 86.4 three weeks ago. Subsequently, the Index turned down to record a figure of 85.0 last week. This takes it back to its range of January-February again. Presumably, the Confidence Index is saying: "A new recovery high -- and a prompt decline!" (3) The Low-Priced Index touched its highest level since 1959 two weeks ago, then drifted off last week. We will have to see what happens to this one. (4) New highs and lows have been adjusted to the new year's basis, but already it can be seen that the indications are not bullish. (5) The short interest ratio rose to .99 in March, the highest reading since October, 1961. Any figure below 1.0 must be considered as no better than neutral, however.

LATE NOTE: As of the March 28 closing, Industrials rallied 5 points above their 707.28 (March 27) closing, while Rails tacked on over a point. Volume on the first day of the rally held below 3 million shares. This takes Industrials to within 11 points of a recovery high (above Z -- 723.54). It also brings the senior Average within 11 points of the first triple divergence between Industrials and the A-D ratio since 1959-60.

STOCKS Of our 56 "key" stocks used in the continuous studies, 26 are now holding above their 10-week moving average. This represents a sharp drop from last week. A few stocks that broke below their moving average were Anaconda, Georgia-Pacific, Republic Steel, Southern Pacific, and Swift.

Among groups now turning noticably weak are aircraft, airlines, cement, tobaccos, rails, and motion pictures. Groups showing strength are containers, textiles and utilities.

In view of the posibility of a triple-divergence between breadth and price as outlined earlier, I do not wish to recommend stocks for purchase at this time. I would much rather see subscribers use any rally from this area as a chance to unload securities (perhaps the most difficult market procedure is that of selling stocks on a rally -- we are going against our emotions).

Should the Industrials rise above 723.54 (unconfirmed by the A-D ratio), I believe the market will be in a position for shorting. Again, however, I have always been extremely cautious about suggesting the short side of the market (particularly when the primary trend, as far as we know it, continues bullish). The strange state of the average investor's emotions as he takes a short position seems to militate against profits (people are normally bullish, dividends must be paid out on stocks that are shorted, losses on the short side are potentially unlimited, while gains are limited to the price of the stock--assuming the stock drops to zero).

Nevertheless, the charts of a few stocks are worth studying from the standpoint of shorting, but I would only want to put out shorts in the event of a recovery high on the Industrial Average above 723.54.

Thiokol collapsed from its 1959 high of 72. From the low of 29 in 1960, the stock rose for a full correction of the downward move. Over the last nine months THI formed a descending right triangle with a base at the 38 level. The chart suggests substantially lower prices on a market break.

Philip Morris rose from 54 to 125 during the 1959-61 period. A "head-and-shoulders" distribution pattern formed during late 1961 and early 1962. The stock is now headed down, but I would try to get shorts off as near to 104 as possible with a "stop-loss" at 106.

Charts courtesy of Traders Research P.O. Box 2644, St. Louis 16, Mo.

Written Thursday, March 29, 10 A.M.